

Internal Revenue Service
memorandum

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Br3:CSShein

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to: Karen J. Goheen, District Counsel, Detroit

from: Chief, Branch 3, Office of Associate Chief
Counsel (International)

subject: [REDACTED]

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You have asked us for informal technical assistance in connection with the examination of [REDACTED]'s Federal income tax return for its fiscal year ended August 31, [REDACTED]. The specific issue on which you have requested assistance is whether section 15(e)¹ applies for purposes of computing the section 904 foreign tax credit limitation.

FACTS

[REDACTED] had foreign source net long term capital gain for its fiscal year ended ("FYE") 8/31/[REDACTED]. [REDACTED] computed its net capital gain tax liability using the alternative rate of tax provided in section 1201, and its foreign tax credit limitation using the section 904(b) rate differential portion.

During [REDACTED]'s FYE 8/31/[REDACTED], the maximum corporate tax rate fell from 46% to 34%, and the maximum capital gain tax rate rose from 28% to 34%. The result, as will be discussed infra, was three capital gain rate differentials for the fiscal year. [REDACTED] computed its foreign tax credit limitations using two rate differentials, one for the pre-1/1/87 period and one for the post-1986 period. [REDACTED] now argues that its tax liability should have been computed using a single weighted average tax rate pursuant to section 15(e).

¹ All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.

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LAW AND DISCUSSION

Prior to its amendment by the Tax Reform Act of 1986 (Pub. L. 99-514) (the "1986 Act"), section 1201(a) provided that a corporation could apply an alternative tax rate of 28 percent on its net capital gain if the alternative tax plus the tax imposed on the corporation's ordinary income pursuant to section 11, 511, 821(a) or (c), or 831(a) was less than the tax that would be imposed on the corporation's net taxable income (ie., the sum of the corporation's ordinary and capital income, gain and loss) pursuant to section 11, 511, 821(a) or (c), or 831(a). For taxable years beginning after December 31, 1986, section 1201 provides that there shall be no alternative tax rate for capital gains unless the maximum corporate tax rate exceeds 34 percent, in which case capital gains shall be taxed at an alternative rate of 34 percent rate if the resulting tax is less than the tax that would be imposed on the corporation's net taxable income pursuant to section 11, 511, or 831(a) or (b). For taxable years beginning in 1986 and ending in 1987, pre-1986 Act law (ie. the 28 percent alternative tax) applies for capital gains or losses arising before January 1, 1987, and section 1201(a) as amended by the 1986 Act applies for the remainder of the taxable year. See section 311(d)(1) of the 1986 Act.

Section 904(a) limits the foreign tax credit allowable under section 901 to an amount that bears the same ratio to the taxpayer's pre-credit United States tax liability as the ratio between the taxpayer's foreign source income and its worldwide taxable income. In other words,

$$\begin{array}{lcl} \text{foreign tax} & & \text{pre-credit} \\ \text{credit limitation} & = & \text{U.S. tax} \end{array} \times \frac{\text{foreign source income}}{\text{worldwide taxable income}}$$

Section 904(b)(2) provides special rules for the inclusion of capital gains or losses in the numerator and denominator of the limitation fraction. The provision was added to remedy problems in the calculation of the foreign tax credit resulting from the difference in tax rates on ordinary income and capital gains. Without section 904(b)(2), a taxpayer with U.S. source ordinary income and foreign source capital gain would obtain a foreign tax credit limitation in excess of its U.S. tax liability attributable to its foreign source income, while a taxpayer with U.S. source capital gain and foreign source ordinary income would have a foreign tax credit limitation lower than its U.S. tax liability attributable to its foreign source ordinary income.

Section 904(b)(2)(B)² provides, for years in which there is a capital gain differential, that the taxable income of a corporation included in the denominator of the limitation fraction (worldwide taxable income) will include gain from the sale or exchange of a capital asset only to the extent of the difference between the corporation's net capital gain (from all sources) and the rate differential portion of such net capital gain. The rate differential portion of net capital gain is a fraction, defined in section 904(b)(3)(E), multiplied by the net capital gain. The numerator of the rate differential fraction is the difference between the ordinary income tax rate and the capital gain rate, and the denominator is the ordinary income tax rate.

Section 15(e),³ added by the Tax and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647) ("TAMRA"), but effective as if included in the 1986 Act, generally provides that if a tax rate change is effective during a taxpayer's taxable year, any reference to the highest rate of tax imposed for the year shall be treated as a reference to the weighted average of the highest tax rates before and after the change. A parenthetical, however, indicates that the weighted average rate does not apply to "a provision imposing a tax by reference to such rate".

For [REDACTED]'s FYE 8/31/[REDACTED], there were two maximum corporate tax rates and two capital gain rates. The maximum corporate tax rate changed from 46 percent to 34 percent effective 7/1/87, and the capital gain tax rate changed from 28 percent

² The section references in this paragraph are to section 904(b) as amended by the Tax Reform Act of 1986 (Pub. L. 99-514) and the Tax and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647) ("TAMRA"), because the TAMRA changes are effective as if included in the 1986 Act and neither the 1986 Act nor TAMRA substantively changed the relevant provisions.

³ Section 15(e) provides:

(e) References to Highest Rate.--If the change referred to in subsection (a) involves a change in the highest rate of tax imposed by section 1 or 11(b), any reference in this chapter to such highest rate (other than in a provision imposing a tax by reference to such rate) shall be treated as a reference to the weighted average of the highest rates before and after the change determined on the basis of the respective portions of the taxable year before the date of the change and on or after the date of the change.

to 34 percent, effective 1/1/87. The result is three section 904(b)(3)(E) rate differentials computed as follows:

	<u>Corporate Tax Rate</u>	<u>Cap. Gain Tax Rate</u>	<u>Rate Differential</u>
pre-1/1/87	46%	28%	18/46
1/1/87-6/30/87	46%	34%	12/46
post-6/30/87	34%	34%	none

argues that the weighted average rate provided for in section 15(e) should be used in computing its capital gain differential for it FYE 8/31/. computes the weighted average tax rate as follows:

pre-7/1/87 /365 x 46% =
post-6/30/87 /365 x 34% =
Weighted Average Rate =

We could argue that section 15(e) does not apply for purposes of computing the capital gain rate differential under section 904(b)(2). Section 15(e) provides that the weighted average rate will not apply to a provision imposing a tax by reference to such rate. The section 904 foreign tax credit limitation is computed with reference to the capital gain rate differential, which is computed with reference to the highest tax rate. Thus, we could argue that in this case the U.S. tax imposed on foreign income is determined by reference to the highest tax rate and section 15(e) does not apply.

The Senate Report on section 15(e) gives as examples of provisions of the Code requiring a determination of the maximum corporate tax rate for purposes other than imposing a tax by reference to such rate sections 904(d)(2)(F) and 954(b)(4), the foreign tax credit and subpart F high-tax kick-outs. S. Rept. 445, 100th Cong., 2d Sess. 39 (1988). These sections provide special treatment for income subject to foreign taxes exceeding the highest rate of tax under section 1 or 11 of the Code (or 90% of such rate in the case of section 954), but do not themselves impose a tax on such income. In general, section 904(d)(2)(F) provides that income subject to a high rate of foreign tax will be treated as general limitation rather than passive income, and section 954(b)(4) provides that income subject to a high rate of foreign tax may be excluded from subpart F income.

We could distinguish section 904(b)(2)(B) from the high-tax kick-out provisions on the grounds that it provides a mechanism for computing taxable income for purposes of computing the section 904 foreign tax credit limitation based on the capital gains rate differential. The U.S. tax on

foreign source income, therefore, is imposed by reference to the capital gain differential, which is computed by reference to the highest rate of tax.

If section 15(e) does not apply, then [REDACTED] in computing its foreign tax credit limitation for its FYE 8/31/[REDACTED], must divide the taxable year into three segments corresponding to the three capital gain rate differentials in effect for the fiscal year. [REDACTED] must compute its foreign tax credit limitation separately for the period beginning September 1 and ending December 31, [REDACTED], using 18/46 as the rate differential fraction, for the period beginning January 1 and ending June 30, [REDACTED], using 12/46 as the rate differential fraction, and for the period beginning July 1 and ending August 31, [REDACTED], during which there was [REDACTED] differential.

We do not, however, believe that we should take the position that section 15(e) does not apply for purposes of computing the capital gains differential. The legislative history indicates that section 15(e) is intended to apply in determining whether income is high-taxed within the meaning of section 904(d). It is difficult to argue that section 15(e) does not apply to computations under section 904(b) while conceding that it applies for computations under section 904(d).

Another argument that could be made is that the taxpayer did not compute its capital gains differentials using a weighted average method as section 15(e) requires. A weighted average should involve taking into account not only the number of days of the year during which each rate was in effect, but also the differences in the amount of income earned during each period. The legislative history, however, provides an example that takes into account only the number of days for which each rate was in effect. Consequently, this is probably not a very strong argument.

If you have any further questions, please contact Caren Shein at FTS 566-3452.


Carol Doran Klein

cc: Nancy B. Herbert, Special Trial Attorney (International)